1999

Service organizations and reporting on consistency; Statement on auditing standards, 088

American Institute of Certified Public Accountants. Auditing Standards Executive Committee

December 1999

88

Statement on Auditing Standards

Issued by the Auditing Standards Board

AICPA

AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS

Service Organizations and Reporting on Consistency

(Amends Statement on Auditing Standards No. 70, Reports on the Processing of Transactions by Service Organizations, *AICPA,* Professional Standards, *vol. 1, AU sec. 324.03 and 324.06–.10, and Statement on Auditing Standards No. 1,* Codification of Auditing Standards and Procedures, *AICPA,* Professional Standards, *vol. 1, AU sec. 420, "Consistency of Application of Generally Accepted Accounting Principles," paragraphs .07–.10.)*

1 2 3 4 5 6 7 8 9 0 AAS 9 9

Service Organizations and Reporting on Consistency

PART 1

Service Organizations

Amendments to Statement on Auditing Standards No. 70,* Reports on the Processing of Transactions by Service Organizations *(AICPA,* Professional Standards, *vol. 1, AU sec. 324.03 and 324.06–.10)

1. This amendment clarifies the applicability of Statement on Auditing Standards (SAS) No. 70, *Reports on the Processing of Transactions by Service Organizations* (AICPA, *Professional Standards*, vol. 1, AU sec. 324), by replacing existing language with the language and concepts in SAS No. 55, *Consideration of Internal Control in a Financial Statement Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 319), as amended by SAS No. 78, *Consideration of Internal Control in a Financial Statement Audit: An Amendment to Statement on Auditing Standards No. 55* (AICPA, *Professional Standards*, vol. 1, AU sec. 319), to state that the SAS is applicable if an entity obtains services from another organization that are part of the entity's information system. It provides guidance to help auditors determine whether services are part of the information system. It also revises and clarifies the factors a user auditor should consider in determining the significance of a service organization's controls to a user organization's controls. In addition, it clarifies the guidance on determining whether information about a service organization's controls is necessary to plan the audit, and that information about a service organization's controls may be obtained from a variety of sources. New language is shown in boldface italics; deleted language is shown by strikethrough.

> 3. The guidance in this section is applicable to the audit of the financial statements of an entity that obtains ~~either or both of the following~~ services from another organization~~:~~ ***that are part of its information system. A service organization's services are part of an entity's information system if they affect any of the following:***
>
> - ~~Executing transactions and maintaining the related accountability~~
> - ~~Recording transactions and processing related data~~
>
> ***a. How the entity's transactions are initiated***

b. ***The accounting records, supporting information, and specific accounts in the financial statements involved in the processing and reporting of the entity's transactions***

c. ***The accounting processing involved from the initiation of the transactions to their inclusion in the financial statements, including electronic means (such as computers and electronic data interchange) used to transmit, process, maintain, and access information***

d. ***The financial reporting process used to prepare the entity's financial statements, including significant accounting estimates and disclosures***

Service organizations that provide such services include, for example, bank trust departments that invest and ~~hold~~ ***service*** assets for employee benefit plans or for others, mortgage bankers that service mortgages for others, and electronic data processing (EDP) service centers that process transactions and related data for others. The guidance in this section may also be relevant to situations in which an organization develops, provides, and maintains the software used by client organizations. The provisions of this section are not intended to apply to situations in which the services provided are limited to executing client organization transactions that are specifically authorized by the client, such as the processing of checking account transactions by a bank or the execution of securities transactions by a broker. This section also is not intended to apply to the audit of transactions arising from financial interests in partnerships, corporations, and joint ventures, such as working interests in oil and gas ventures, when proprietary interests are accounted for and reported to interest holders.

The Effect of *Use of* a Service Organization on a User Organization's Internal Control

6. When a user organization uses a service organization, transactions that affect the user organization's financial statements are subjected to controls that are, at least in part, physically and operationally separate from the user organization. The ~~relationship~~ ***significance*** of the controls of the service organization to those of the user organization depends ~~primarily~~ on the nature of the services provided by the service organization, ***primarily the nature and materiality of the transactions it processes for the user organization and the degree of interaction between its activities and those of the user organization. To illustrate how the degree of interaction affects user organization controls,*** ~~For example,~~ when ***the user organization initiates transactions and the service organization***

executes and does the accounting processing of those transactions, ~~those services are limited to recording user transactions and processing the related data, and the user organization retains responsibility for authorizing transactions and maintaining the related accountability~~ there is a high degree of interaction between the ~~controls~~ ***activities*** at the ~~service~~ ***user*** organization and those at the ~~user~~ ***service*** organization. In these circumstances, it may be ~~possible~~ ***practicable*** for the user organization to implement effective controls for those transactions. ***However, when*** ~~When~~ the service organization ***initiates,*** executes, ***and does the accounting processing of*** the user organization's transactions ~~and maintains the related accountability~~, there is a lower degree of interaction and it may not be practicable for the user organization to implement effective controls for those transactions. ~~The degree of interaction, as well as the nature and materiality of the transactions processed by the service organization, are the most important factors in determining the significance of the service organization's controls to the user organization's internal control.~~

Planning the Audit

7. AU Section 319, *Consideration of Internal Control in a Financial Statement Audit*, states that an auditor should obtain an understanding of each of the five components of an entity's internal control sufficient to plan the audit. This understanding ***may encompass controls*** ~~should include knowledge about the design of controls relevant to the audit of financial statements and whether they have been~~ placed in operation by the entity ***and by service organizations whose services are part of the entity's information system***. In planning the audit, such knowledge should be used to—

- Identify types of potential misstatements.
- Consider factors that affect the risk of material misstatement.
- Design substantive tests.

~~8. If an entity uses a service organization, certain controls and records of the service organization may be relevant to the user organization's ability to record, process, summarize, and report financial data consistent with the assertions embodied in the entity's financial statements. In determining the significance of these controls and records to planning the audit, the user should consider factors such as—~~

- ~~The significance of the financial statement assertions that are affected by the controls of the service organization.~~
- ~~The inherent risk associated with the assertions affected by the controls of the service organization.~~

- ~~The nature of the services provided by the service organization and whether they are highly standardized and used extensively by many user organizations or unique and used only by a few.~~
- ~~The extent to which the user organization's controls interact with the controls of the service organization.~~
- ~~The user organization's controls that are applied to the transactions affected by the service organization's activities.~~
- ~~The terms of the contract between the user organization and the service organization (for example, their respective responsibilities and the extent of the service organization's discretion to initiate transactions).~~
- ~~The service organization's capabilities, including its —~~
  - ~~Record of performance.~~
  - ~~Insurance coverage.~~
  - ~~Financial stability.~~
- ~~The user auditor's prior experience with the service organization.~~
- ~~The extent of auditable data in the user organization's possession.~~
- ~~The existence of specific regulatory requirements that may dictate the application of audit procedures beyond those required to comply with generally accepted auditing standards.~~

~~9~~.*8*. ***Information about the nature of the services provided by a service organization that are part of the user organization's information system and the service organization's controls over those services may be available from a wide variety of sources*** ~~The user auditor should also consider the available information about the service organization's controls, including (a) the information in the user organization's possession~~, such as user manuals, system overviews, ~~and~~ technical manuals, ***the contract between the user organization and the service organization,*** and ~~(b) the existence of reports on the service organization's controls, such as~~ reports by service auditors, internal auditors ~~(the user organization's or the service organization's)~~, or regulatory authorities ***on the service organization's controls. If the services and the service organization's controls over those services are highly standardized, information obtained through the user auditor's prior experience with the service organization may be helpful in planning the audit.***

~~10~~.**9**. After considering ~~the above factors and evaluating~~ the available information, the user auditor may conclude that he or she has the means to obtain a sufficient understanding of internal control to plan the audit. If the user auditor concludes that information is not available to obtain a sufficient understanding to plan the audit, he or she may consider contacting the service organization, through the user organization, to obtain specific information or request that a service auditor be engaged to perform procedures that will supply the necessary information, or the user auditor may visit the service organization and perform such procedures. If the user auditor is unable to obtain sufficient evidence to achieve his or her audit objectives, the user auditor should qualify his or her opinion or disclaim an opinion on the financial statements because of a scope limitation.

2. This amendment changes the title of SAS No. 70 from *Reports on the Processing of Transactions by Service Organizations* to *Service Organizations*.

3. This amendment is effective upon issuance.

PART 2
Reporting on Consistency

Amendments to Statement on Auditing Standards No. 1,* Codification of Auditing Standards and Procedures *(AICPA,* Professional Standards, *vol. 1, AU sec. 420, "Consistency of Application of Generally Accepted Accounting Principles," paragraphs .07–.10)

4. This amendment conforms the list of changes that constitute a change in the reporting entity, (Statement on Auditing Standards No. 1, *Codification of Auditing Standards and Procedures* [AICPA, *Professional Standards*, vol. 1, AU sec. 420.07]) to the guidance in paragraph 12 of Accounting Principles Board (APB) Opinion No. 20, *Accounting Changes*. It also clarifies that the auditor need not add a consistency explanatory paragraph to the auditor's report when a change in the reporting entity results from a transaction or event. In addition, it eliminates the requirement for a consistency explanatory paragraph in the auditor's report if a pooling of interests is not accounted for retroactively in comparative financial statements. However, in these circumstances, the auditor would still be required to express a qualified or adverse opinion because of the departure from generally accepted accounting principles. Finally, it eliminates the requirement to qualify the auditor's report and consider adding a consistency explanatory paragraph to the report if single-year financial statements that report a pooling of interests do not disclose combined information for the prior year. New language is shown in boldface italics; deleted language is shown by strikethrough.

Change in the Reporting Entity

7. ~~Since a~~ ***A*** change in the reporting entity is a special type of change in accounting principle~~,~~ ***which results in financial statements that, in effect, are those of a different reporting entity.*** ~~the consistency standard is applicable. Changes in reporting entity that require recognition in the auditor's report include:~~ ***This type is limited mainly to—***

a. Presenting consolidated or combined statements in place of statements of individual companies.

b. Changing specific subsidiaries comprising the group of companies for which consolidated statements are presented.

c. Changing the companies included in combined financial statements.

~~d. Changing among the cost, equity, and consolidation methods of accounting for subsidiaries or other investments in common stock.~~

A business combination accounted for by the pooling of interests method also results in a different reporting entity.[4]

~~**Reports Following a Pooling of Interests**~~

8. A change in the reporting entity resulting from a transaction or event, such as a pooling of interests, or the creation, cessation, or complete or partial purchase or disposition of a subsidiary or other business unit, does not require that an explanatory paragraph about consistency be included in the auditor's report. A change in the reporting entity that does not result from a transaction or event requires recognition in the auditor's report through inclusion of an explanatory paragraph.

~~8.~~**9.** When companies have merged or combined in ~~accordance with the accounting concept known as~~ a ~~"~~pooling of interests,~~"~~ appropriate effect of the pooling should be given in the presentation of financial position, results of operations, cash flows, and other historical financial data of the continuing business for the year in which the combination is consummated and, in comparative financial statements, for years prior to the year of pooling, as described in APB Opinion No. 16, *Business Combinations* [AC section B50]. If prior year financial statements, presented in comparison with current year financial statements, are not restated to give appropriate recognition to a pooling of interests, ***a departure from generally accepted accounting principles has occurred which necessitates that the auditor express a qualified or an adverse opinion as discussed in SAS No. 58,* Reports on Audited Financial Statements *(AICPA,* Professional Standards, *vol. 1, AU sec. 508.35–.40). Since the inconsistency arises not from a change in the application of an accounting principle in the current year, but from the lack of such application to prior years, an explanatory paragraph (in addition to the modification relating to the departure from generally accepted accounting principles) is not required.*** ~~the comparative financial statements are not presented on a consistent basis. In this case, the inconsistency arises not from a change in the application of an accounting principle in the current year, but from the lack of such application to prior years. Such inconsistency would require the auditor to add an explanatory paragraph to the report. In addition, failure to give appropriate recognition to the pooling in comparative financial statements is a departure from generally accepted accounting principles.~~

---

4. APB Opinion 20, paragraph 12.

~~9. When single year statements only are presented for the year in which a combination is consummated, a note to the financial statements should adequately disclose the pooling transaction and state the revenues, extraordinary items, and net income of the constituent companies for the preceding year on a combined basis. In such instances, the disclosure and consistency standards are met. Omission of disclosure of the pooling transaction and its effect on the preceding year would require the auditor to qualify the opinion because of the lack of disclosure and may also require the auditor to add an explanatory paragraph to the report because of the inconsistency (see footnote 16 of section 508.52).~~

~~10. For purposes of application of the consistency standard, a change in reporting entity does not result from the creation, cessation, purchase, or disposition of a subsidiary or other business unit.~~

5. This amendment is effective upon issuance.

This Statement entitled Service Organizations and Reporting on Consistency *was adopted by the assenting votes of fourteen members of the board. One member of the board was unable to vote for health reasons.*

Auditing Standards Board (1999)

Deborah D. Lambert, *Chair*
James S. Gerson, *Vice Chair*
John Barnum
Andrew J. Capelli
Robert F. Dacey
Richard Dieter
Sally L. Hoffman
Stephen D. Holton
J. Michael Inzina
Charles E. Landes
Keith O. Newton
Alan Rosenthal
Robert C. Steiner
George H. Tucker
O. Ray Whittington

Thomas Ray
Director
Audit and Attest Standards
Judith M. Sherinsky
Technical Manager
Audit and Attest Standards

Reporting on Consistency Task Force

Richard Dieter, *Chair*
Andrew J. Capelli
Stephen D. Holton
J. Michael Inzina
Kurt Pany

Financial Instruments Task Force (Service Organization Controls)

Stephen D. Holton, *Chair*
Richard Brezovec
Andrew J. Capelli
Andrew E. Nolan
Steven Paraggio
Alan Rosenthal
George H. Tucker

Note: *Statements on Auditing Standards are issued by the Auditing Standards Board, the senior technical body of the Institute designated to issue pronouncements on auditing matters. Rule 202 of the Institute's Code of Professional Conduct requires compliance with these standards.*

www.aicpa.org

060690